

# ANALYSIS OF ORIGINAL BILL

## Franchise Tax Board

Author: Cohn Analyst: Gloria McConnell Bill Number: AB 2781  
Related Bills: See Legislative History Telephone: 845-4336 Introduced Date: 02/25/02  
Attorney: Patrick Kusiak Sponsor: \_\_\_\_\_

**SUBJECT:** Franchise Tax Board Electronic Filing/ Prohibits Use of Specific Electronic Products, Services, System, Software, or Computer Code.

### SUMMARY

This bill would restrict Franchise Tax Board's (FTB) use of electronic (e-) technology.

### PURPOSE OF THE BILL

According to the author's office, the purpose of this bill is to build consumers' confidence and protect taxpayers' privacy when e-filing their income tax returns with FTB.

### EFFECTIVE/OPERATIVE DATE

This bill would be effective and operative on January 1, 2003.

### POSITION

No Position. This bill was considered for position by FTB at its meeting of March 25, 2002. No position was taken because the author's staff represented to the Board that the bill would be amended. No subsequent amendments have been made to the bill.

### Summary of Suggested Amendments

Amendments may be forthcoming, as discussed under "Implementation Considerations."

### ANALYSIS

#### FEDERAL/STATE LAW

Under federal law, income tax returns are in a form prescribed by the Secretary of the Treasury.

Federal income tax law has several provisions relating to e-filing returns with the Internal Revenue Service (IRS). Under these provisions, the Secretary is:

- authorized to promote the benefits and encourage the use of e-tax administration programs;
- required to develop procedures for the acceptance of signatures in digital and other e-signatures; and
- authorized to provide regulations for the delivery and postmark date for e-filing.

Board Position:

<input type="checkbox"/> S	<input type="checkbox"/> NA	<input checked="" type="checkbox"/> NP
<input type="checkbox"/> SA	<input type="checkbox"/> O	<input type="checkbox"/> NAR
<input type="checkbox"/> N	<input type="checkbox"/> OUA	<input type="checkbox"/> PENDING

Department Director

Date

Gerald H. Goldberg

04/17/02

Under current state income tax law<sup>1</sup> relating to e-filing:

- income tax returns must be in a form prescribed;
- taxpayers must sign written declarations under penalty of perjury.

Under current state income tax law, FTB is required to examine returns and determine the correct amount of tax. This requires FTB to determine whether the taxpayer has self-assessed the correct amount of tax imposed under the law. For tax returns filed with FTB, the law provides that, for such determinations, the tax return or e-stored return data must be examined and in no case may the determination be arbitrary or without foundation. For the purpose of this examination, e-stored return data is defined as e-records of line items from an original or amended return. If FTB determines the taxpayer under-assessed the tax, a notice of proposed deficiency assessment (NPA) is issued. Taxpayers may protest an NPA and subsequently appeal FTB's action on the protest of the NPA, if the taxpayer so desires.

### Current Practice

From FTB's mission statement: The purpose of FTB is to collect the correct amount of tax revenue and operate other programs entrusted to us; serve the public by continually improving the quality of our products and services; and perform in a manner warranting the highest degree of public confidence in our integrity, efficiency and fairness.

### FTB e-products and services that determine or calculate tax liability

FTB's mainframe computer systems and other e-systems were developed or made available to determine or calculate a taxpayer's income tax liability. This is a routine part of the processing of the tax return and determining whether the correct tax liability is shown on the tax return.

In addition, online e-products and services are used by taxpayers and the general public. These tax forms are published online for taxpayers to download, prepare, and mail, or to just view and use for purposes of completing their paper or e-forms, including tax returns. Tax publications, legal ruling, regulations, and other publications or documents also are made available online with the purpose in some way to determine a taxpayer's income tax liability. Also, available online is a calculator that taxpayers can use instead of the tax tables or tax rate schedules to complete their tax returns.

Further, the Telefile system allows taxpayers to enter data through the telephone keys. The e-system determines the tax based on that data and the data is submitted, which becomes the tax return.

### FTB e-tax forms

For taxpayers to prepare tax returns, the FTB provides online a variety of e-tax forms, which includes tax returns, schedules, instructions, special publications, and tax booklets. To allow taxpayers to e-prepare the required returns, all of the forms and many of the simpler schedules can be downloaded to taxpayers' personal computers. In e-preparing the returns, taxpayers do all math functionality, seek tax advice through the tax form booklets offered by FTB, or elsewhere. Taxpayers must then print the completed tax returns and mail them to FTB.

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<sup>1</sup> For purposes of this analysis, "income tax law" refers to the Personal Income Tax Law, the Corporation Tax Law and the Administration of Franchise and Income Tax Laws. Unless specified otherwise, reference to "taxpayers" means taxpayers subject to these laws.

### E-preparation and filing partnership between business and FTB

With the growth of technology, there are three ways to e-prepare an income tax return through the following businesses: (1) tax professionals that utilize tax preparation software to complete the tax return, (2) tax preparation software purchased by taxpayers to install on their personal computer, and (3) tax preparation programs that taxpayers can access with their personal computer via the Internet. All these services do basic arithmetic functions (mathematical addition and subtraction), mathematical calculations (multiplication, adjustments, populating fields, etc.), offer some form of tax advice, and determine or calculate the tax liability for taxpayers.

Taxpayers can e-file tax returns through businesses in three ways: (1) tax practitioners that generally transmit the tax returns from their computer system (on which the return resides) to a third party transmitter and then to FTB's computer system, (2) tax preparation software purchased by taxpayers or on-line tax preparation programs of service providers that transmits the taxpayer's tax return electronically to FTB's computer system using the service providers computer system (on which the return resided), and (3) the direct filing portal which was developed to allow taxpayers the opportunity to use their own Internet service provider to file directly with FTB. However, the only businesses that offer the direct portal filing opportunity requires taxpayers to use the businesses' Internet service provider. The taxpayer's return resides on those businesses' computer system.

The business' e-cost for these services vary. Tax practitioners generally charge a fee for e-tax preparation and the associated e-filing. However, several of these businesses offer free e-tax preparation and filing services if the individual's adjusted gross income is below a specified amount or if the individual is filing a simple Form 540 2EZ. Such free services are not required by law, therefore, are subject to change by the business and could be withdrawn at will at any time. The cost for using tax preparation software/programs often includes the e-filing services.

A significant advantage of using business to complete tax returns, including software/programs, is that business prepares both state and federal income tax returns.

### Other California Taxing Agencies

EDD and Board of Equalization (BOE) have each developed and have made available online tax forms, publications, and other information that in some way determine or calculate a taxpayer's tax liability. Some of these e-products or services may be used online. Also, EDD has available for household employers an online e-product or service for reporting, filing, and paying their taxes. This e-product or service determines or calculates the employer's tax liability and is submitted by the taxpayer directly to EDD.

### **OTHER STATES' INFORMATION**

E-technology products and services that are offered in other states vary. A chart that displays the variations is provided at the Federation of Tax Administrators (FTA) website<sup>2</sup> ([www.taxadmin.org/fta/edi/trend.ssi](http://www.taxadmin.org/fta/edi/trend.ssi)). According to other FTA documents<sup>3</sup> e-programs offered by the various states are free and perform basic arithmetic and tax calculation functions. Some of the more advanced state-direct online filing feature customized online forms designed to request only the relevant information needed from a specific filer.

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<sup>2</sup> "Status of State Electronic Filing Programs for Individual Income Tax"

<sup>3</sup> "State Electronic Tax Administration, Briefing Paper, May 2001"

For additional information, Appendix A provides a chart prepared by FTB staff of the 17 states that offer taxpayers direct online e-preparation and e-filing without the use of a third party intermediary. Appendix B provides a chart that reflects the length of time that taxpayer return data may be retained by those state taxing agencies from which FTB was able to readily obtain information. Additionally, TaxExPRESS, a weekly electronic newsletter for state tax agencies, reports that Missouri has enhanced its paper-based Internet income tax form to add full math calculations and to calculate the tax due.

### THIS BILL

Under this bill, FTB would be prohibited from:

1. developing or making available e-products or services that would in any way determine or calculate a taxpayer's income tax liability.
2. employing the use of any system, software or computer code, online or interactive system, or associated technologies that would electronically record, capture, store, observe, or monitor any usage or preparation of electronic tax forms transmitted by a taxpayer, other than the final form transmitted by or on behalf of the taxpayer to FTB.

### IMPLEMENTATION CONSIDERATIONS

Under the first prohibition in this bill (subdivision (a) of Section 18621.3), FTB's current e- practices and procedures for the administration of the income tax laws would be impacted depending upon the interpretation given to this provision. In its broadest interpretation, this prohibition would forbid most electronic systems already in use by FTB because the basic nature of activity conducted by a taxing agency is to determine or calculate the correct tax liability. This prohibition could change the way tax returns are currently e-prepared and e-submitted to FTB through its partnership with tax preparers or tax preparation software providers. Currently, before an e-submitted tax return is accepted by FTB, each return is checked by computer to validate that all data necessary for processing is included, such as two names and social security numbers for a joint return, and the arithmetic is correct. Hence, tax preparers or taxpayers are asked to log back on after submitting their return to verify that the tax return has been accepted. Under this bill, this computer validation process would be prohibited since the validation could be construed as determining or calculating a taxpayer's income tax liability.

The following are some of the uncertainties surrounding the broad language of the first prohibition and its intended meaning of these phrases:

- "determine or calculate": When FTB is processing and validating tax returns through its mainframe computer systems, whether e-filed or on paper, FTB is actually determining or calculating the taxpayer's tax, which appears to be prohibited by this bill.

The booklet provided online provides "tips" and tax tables for the taxpayer to use to successfully prepare a correct tax return. It is uncertain whether these "tips" and the tax tables would be prohibited as an e-product under this bill.

- "income tax liability": It is uncertain whether this phrase includes an income tax liability of which part may be unpaid or due to be paid. It is uncertain whether FTB would be precluded from allowing taxpayers to make on-line installment payment arrangements, verify estimated tax payments, or check the current balance of income tax liabilities. All of these processes require the taxpayer or FTB to determine or identify the "income tax liability" that is due.

Under the second prohibition in this bill, (subdivision (b) of Section 18621.3), a broad description of activities that would be prohibited relating to e-tax forms is provided. Under this subdivision, FTB would be prohibited from e-recording, capturing, storing, observing, or monitoring any usage of e-tax forms, other than the final form transmitted. From discussion with the author's office, the intent of this provision centers on concern that FTB may be capturing or some how obtaining key-strokes where the taxpayer may have entered one number in a draft form, but corrected it with another number in the "final" version of the form. Perhaps this focus could be clarified in the language.

Clarification could also resolve the following considerations:

- whether monitoring any usage would mean FTB could no longer monitor how many people download tax forms from FTB's website, or monitor the number of taxpayers that may inquire into the online services of making estimated payments or installment payment arrangements, which is anticipated to be online shortly.
- whether "form" ("electronic tax forms" and "final form") means only tax returns or any forms used for income tax purposes. Online e-products or services typically require taxpayers to key in and submit their customer service number for validation. Once validated by FTB, taxpayers will continue the process by entering and submitting additional information, which again is validated. It appears this bill would prohibit this validation process, as well as the validation process required for e-filed returns, which was previously discussed, because FTB would be using information from forms preceding the submission or acceptance of the "final" form. For Telefile, some taxpayers make entry errors using their telephone key-pad, such as transposing digits of a social security number. It is uncertain whether FTB would have to discontinue Telefile because those errors or other information are capable of being captured by FTB.

FTB staff is available to work with the author's staff to draft language that will achieve the author's intent and resolve FTB's implementation considerations.

## **LEGISLATIVE HISTORY**

SB 415 (Dunn; 2001-02) would have required FTB to provide individuals, free of charge, tax return forms that could be e-filed directly with FTB. This bill was held in Assembly Appropriations Committee.

SB 445 (Burton; Stats 2001, Ch. 670) emphasizes that FTB's tax proceedings are to be used to determine the taxpayer's correct tax liability.

AB 1936 (Horton; 2002) would allow taxpayers that are subject to the special tax laws administered by the Board of Equalization (BOE) to e-file their required tax returns in a form prescribed by the BOE.

## **FISCAL AND ECONOMIC IMPACT**

Given the implementation uncertainties, the costs to the department to implement this bill is unknown and a revenue estimate cannot be determined.

## **ARGUMENTS/POLICY CONCERNS**

- In its broadest interpretation, this bill would prevent FTB from administering the tax laws, from achieving its purpose according to its mission statement, or from fulfilling its responsibilities to the public. In addition, the e-file processing presently in place would have to be revisited to ensure that FTB would be in compliance with the provisions of this bill.
- The impact of this bill appears to be beyond what the author intends. Privacy, which is the primary concern of this bill according to the author's staff, is of importance to FTB. FTB takes substantial precautions to assure that taxpayer information is secure. The nature of an e-system necessitates the capturing of information. This information is maintained to manage the integrity of the system. This information is not on the taxpayer's file or readily identifiable as belonging to the taxpayer. The information is used solely for administrative purposes to detect system threats or to investigate the filing of fraudulent tax returns.
- Case law prohibits FTB from making arbitrary taxpayer assessments that lack basis or foundation. It is established case law that the taxing authority must rely on some concrete data in computing a deficiency. The fact that taxpayers change a tax form entry while preparing their returns or the changed entries themselves would not be concrete data sufficient to make an assessment.
- Currently, taxpayers may make errors when completing paper returns. The errors may remain legible on the return. These legible marks are analogous to keystrokes made while preparing an electronic return.
- Another part of FTB's mission statement is to serve the public by continually improving the quality of our products and services. When government requires its citizens to file income tax returns and pay the correct amount of tax, government should have some obligation to give the public the tools it needs to comply with that law, free of charge. It is a policy issue whether taxpayers should have to pay a business to comply with the income tax filing requirements.
- When taxpayers rely on business to e-prepare or file their tax returns, typically their tax return information resides with that business. That business has the capability of engaging in the activities that this bill would prohibit FTB from doing. In the interest of privacy, it is unclear whether it is appropriate for the prohibition of these activities to apply only to government.
- FTA's "Electronic Commerce Best Practices" publication on its website indicates that the Internet offers an incredible flexibility for taxing agencies. This bill would exclude California taxpayers from the flexibility that the Internet offers and that at least 17 other states offer their taxpayers.

## **LEGISLATIVE STAFF CONTACT**

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## Appendix A

The following States (17 total) offer direct Internet filing of Personal Income Tax returns. 16 states host the application on their web site, one state (Oklahoma) links citizens to a customized version of TurboTax for the Web which is not hosted on the state web site.

	Fillable form format	Does Calculations	Q & A format	Built in-house	Vendor built	Transmit via 3 <sup>rd</sup> Party	Transmit via modem or Internet	Application determines form type, or T/P chooses
Arkansas	Yes	Yes		Yes		Direct	Internet	1 tax form, same as TeleFile.
Colorado	Yes	Yes & edits		Yes		Direct	Internet	Only 1 tax form
Delaware	Yes	Yes		Yes		Direct	Internet	TP chooses
Iowa	Yes	Yes			Yes	Direct	Internet	Only 1 tax form
Illinois		Yes	Yes		Yes	Direct	Internet	Only 1 tax form
Indiana	Yes	Yes		Other State agency		Direct	Internet	TP Chooses
Louisiana*		Yes	Yes	Yes		Direct	Internet	Only 1 tax form
Maine		Yes	Yes		Yes	Direct	Internet	
Maryland		Yes	Yes	Yes		Direct	Internet	App chooses
Massachusetts	Yes	Yes	Few		Yes	Direct	Internet	TP chooses, System Q & A to assist if T/P is unsure of form type.
Missouri		Yes	Yes	Yes		Direct	Internet	1 tax form, same as TeleFile.
New Mexico	Yes	Yes		Other state agency		Direct	Internet	Only 1 tax form
Oklahoma	Provides free e-filing through TurboTax.							
Pennsylvania	Yes	Yes	Few		Yes	Direct	Internet	Only 1 tax form
So. Carolina	Yes	Yes			Yes			
Vermont*	Yes	Yes	Few		Yes	Direct	Internet	Only 1 tax form
Virginia*		Yes			Yes	Direct	Internet	Only 1 tax form

### Notes:

\*No response was received, information was obtained from their websites.

- Of the 13 respondents, 10 require Federal AGI prior to filing state return.
- Many of the states allow Tax Practitioners to use the state's system.
- Maine offers a demo at [http://janus.state.me.us/revenue/netfile/1040demo/lfile\\_demo\\_welcome.htm](http://janus.state.me.us/revenue/netfile/1040demo/lfile_demo_welcome.htm)

## Appendix B

### ***Data Retention of Internet Filed Returns Conducted by Selected States***

<b>State</b>	<b>Option to save draft or interim return?</b>	<b>How long is draft information saved?</b>	<b>What happens to data?</b>	<b>Who hosts the Internet application?</b>
Arkansas	No		Not stored, unless return is completed.	State
Colorado	Yes	Through Oct. extension date	Stored, purged after Oct. extension date.	State
Illinois	No		Not stored, unless return is completed.	State
Indiana	Yes	2 weeks	Stored for 2 weeks then purged, unless return is completed.	State
Iowa	Yes	48 hours	Stored for 48 hours then purged, unless return is completed.	Vendor, GovConnect.
Louisiana	No		Not stored, unless return is completed.	State
Oklahoma	Yes	Through Oct. extension date	Stored indefinitely.	Vendor, Intuit.
Pennsylvania	No		Not stored, unless return is completed.	Vendor, GovConnect
So. Carolina	No		Not stored, unless return is completed.	State
Wisconsin	No		Not stored, unless return is completed.	State